No. 18-457

# In the Supreme Court of the United States

NORTH CAROLINA DEPARTMENT OF REVENUE,
*Petitioner,*

v.

THE KIMBERLY RICE KAESTNER 1992 FAMILY TRUST,
*Respondent.*

*On Writ of Certiorari to the North Carolina Supreme Court*

## BRIEF FOR MINNESOTA AND NINETEEN OTHER STATES AND THE DISTRICT OF COLUMBIA AS AMICI CURIAE SUPPORTING THE PETITIONER

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## QUESTION PRESENTED

Does the Due Process Clause prohibit states from imposing income taxes on trusts that are administered outside their borders if the trust's beneficiaries are domiciled in the taxing state?

## TABLE OF CONTENTS

QUESTION PRESENTED ..... i

TABLE OF AUTHORITIES ..... iii

INTEREST OF *AMICI CURIAE* ..... 1

SUMMARY OF ARGUMENT ..... 2

ARGUMENT ..... 3

I. THE NORTH CAROLINA SUPREME COURT'S DECISION REPRESENTS A REVERSION TO A FORMALISTIC DUE PROCESS STANDARD THAT DISREGARDS ESSENTIAL TRUST CONTACTS ... 3

A. The North Carolina Supreme Court's Decision Conflicts With This Court's Modern Due Process Jurisprudence ..... 3

B. The North Carolina Supreme Court's Decision Conflicts With This Court's Trust Taxation Jurisprudence ..... 7

II. THE DECISION BELOW WOULD IMPOSE A STRAIGHTJACKET ON STATES AND CAST IN DOUBT THE MAJORITY OF STATES' TAXING REGIMES ..... 9

III. IF THE DECISION OF THE NORTH CAROLINA SUPREME COURT IS AFFIRMED, IT WILL CREATE A CONSTITUTIONALIZED TAX LOOPHOLE FOR TRUST BENEFICIARIES ..... 13

CONCLUSION ..... 16

## TABLE OF AUTHORITIES

### CASES

*Chase Manhattan Bank v. Gavin*,
733 A.2d 782 (Conn. 1999) . . . . . 6

*Curry v. McCanless*,
307 U.S. 357 (1939). . . . . 7, 8, 9

*Dist. of Columbia v. Chase Manhattan Bank*,
689 A.2d 539 (D.C. 1997) . . . . . 6

*Fielding v. Comm'r of Revenue*,
916 N.W.2d 323 (Minn. 2018). . . . . 5, 14, 15

*Int'l Shoe Co. v. Wash.*,
326 U.S. 310 (1945). . . . . 4

*Lunding v. N.Y. Tax Appeals Tribunal*,
522 U.S. 287 (1998). . . . . 4, 6, 9

*Madden v. Kentucky*,
309 U.S. 83 (1940). . . . . 9

*McCulloch v. Franchise Tax Bd.*,
390 P.2d 412 (Cal. 1964). . . . . 6

*Moorman Mfg. Co. v. Bair*,
437 U.S. 267 (1978). . . . . 4

*People of State of N. Y. ex rel. Cohn v. Graves*,
300 U.S. 308, 57 S. Ct. 466,
81 L. Ed. 666 (1937) . . . . . 16

*Quill Corp. v. North Dakota*,
504 U.S. 298 (1992). . . . . 2, 4, 6

*South Dakota v. Wayfair, Inc.*,
138 S. Ct. 2080 (2018) . . . . . 2, 6, 12, 13

*St. Louis Sw. R. Co. v. Ark.*,
235 U.S. 350 (1914) . . . . . 4

*T. Ryan Legg Irrevocable Trust v. Testa*,
75 N.E3d 184 (Ohio 2016) . . . . . 6

*Westfall v. Dir. of Revenue*,
812 S.W.2d 513 (Mo. 1991) . . . . . 5, 6

**STATUTES**

Ala. Code § 40-18-1(33) (2018) . . . . . 11

A.R.S. § 43-1301 (2018) . . . . . 10

Ark. Code Ann. § 26-51-201(a) (2018) . . . . . 10

Cal. Rev. & Tax. Code § 17041 . . . . . 11, 12

Cal. Rev. & Tax. Code § 17731 . . . . . 11, 12

Cal. Rev. & Tax. Code § 17742 . . . . . 11, 12

Cal. Rev. & Tax. Code § 17743 . . . . . 11, 12

Cal. Rev. & Tax. Code § 17745 (2018) . . . . . 12

Colo. Rev. Stat. § 39-22-103(10) (2018) . . . . . 10

Conn. Gen. Stat. § 12-701 (2018) . . . . . 10

D.C. Code § 47-1809.01 (2018) . . . . . 11

Del. Code Ann. tit. 30 § 1601 (2018) . . . . . 10, 11

Del. Code Ann. tit. 30, § 1601(8) (2018) . . . . . 11

Ga. Code Ann. § 48-7-20(d) (2018) . . . . . 11

Haw. Rev. Stat. § 235-1 (2018) ..... 10
Idaho Code § 63-3015 (2018) ..... 11
35 Ill. Comp. Stat. § 701-89.3 (2018)..... 11
35 Ill. Comp. Stat. 5/201 (2018)..... 11
Ind. Admin. Code tit. 45, r. 3.1-1-12 (2018 ..... 10
Iowa Admin. Code § 701-89.3 (2018)..... 11
Kan. Stat. Ann. § 79-32,109(d) (2018)..... 10
Ky. Rev. Stat. Ann. § 141.030 (2018)..... 10
La. Stat. Ann. § 47:300.10 (2018) ..... 11
Mass. Code Regs. § 62.10.1 (2018)..... 10
Md. Code Ann., Tax-Gen. § 10-101 (2018)..... 11
Me. Rev. Stat. Ann. tit. 36, § 5102(4) (2018)..... 11
830 Mass. Code Regs. § 62.10.1 (2018) ..... 10
Mich. Comp. Laws § 206.18 (2018) ..... 11
Minn. Stat. § 290.01 (2018) ..... 11
Minn. Stat. § 290.01, subd. 7b (2018) ..... 10
Miss. Code Ann. § 27-7-5(1) (2018) ..... 10
Mo. Rev. Stat. § 143.331 (2018)..... 11
Mont. Admin. R. 42.30.101 (2018)..... 11
Neb. Rev. Stat. Ann. § 77-2714.01 (2018)..... 11
N.H. Rev. Stat. Ann. § 77:10 (2018) ..... 11

N.J. Stat. Ann. § 54A:1-2 (2018) ..... 11

N.M. Stat. Ann. § 7-2-2(S) (2018) ..... 10

N.Y. Tax Law § 605 (2018). ..... 11

N.C.G.S.A. § 105-160.2 (2018) ..... 11

N.D. Admin R. 81-03-02.1-04 (2018) ..... 11

Ohio Rev. Code § 5747.01(I)(3) ..... 11

Okla. Stat. tit. 68, § 2353 (2018) ..... 11

Or. Rev. Stat. § 316.282(1)(d) (2018) ..... 10

72 Pa. Cons. Stat. § 7301 (2018) ..... 11

R.I. Gen. Laws § 44-30-5 (2018). ..... 11

S.C. Code Ann. § 12-6-30(5) (2018) ..... 10

Tenn. Code Ann. § 67-2-110(a) (2018) ..... 11

Utah Code Ann. § 59-10-201 (West 2018) ..... 11

Va. Code Ann. § 58.1-302 (2018) ..... 11

Vt. Stat. Ann. tit. 32, § 5811 (2018). ..... 11

W. Va. Code R. 110- 21-7 (West 2018). ..... 11

Wis. Stat. § 71.14(3) (2018) ..... 11

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Restatement (Third) of Trusts (2003) ..... 4

Dave Rifkin, *A Primer on the "Tax Gap" and Methodologies for Reducing It*, 27 Quinnipiac L. Rev. 375 (2009) ..... 14

Jay Soled and Mitchell Gans, *Asset Preservation and the Evolving Role of Trusts in the Twenty-First Century*, 72 Wash. & Lee L. Rev. 257 (2015) ..... 13, 14, 15

Stewart Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 Cornell L. Rev. 1035 (2000) ..... 13

John Warnick and Sergio Pareja, *Selecting a Trust Situs in the 21st Century*, 16 Probate & Property 53 (2002) ..... 14

## INTEREST OF *AMICI CURIAE*

Pursuant to Supreme Court Rule 37, Minnesota, nineteen other states, and the District of Columbia respectfully submit this brief of *amici curiae* in support of the Petitioner, the State of North Carolina Department of Revenue.

*Amici curiae* are states with grave concerns about the due process and state sovereignty implications of the North Carolina Supreme Court's ruling in this case. The *amici* states, with the exception of Washington, rely on income taxes to operate and provide essential services to their residents. This case addresses the taxation of trusts, which states tax on a variety of bases, all of which require contact with the taxing state. Some, like North Carolina, tax based on the domicile of the beneficiary; others, like Minnesota, tax based on the location of the grantor; and still others focus on different contacts a trust has with the state. *Amici* are united in opposing the constrained contacts analysis set out in the North Carolina Supreme Court's decision. That decision, if affirmed, would call into question the constitutionality of the statutes of a large majority of states, and would potentially cost the states billions of dollars in tax revenue. It would also result in a "judicially created tax shelter," allowing trusts to avoid paying income taxes to *any* state.

The Due Process Clause does not require that result. The North Carolina Supreme Court's decision applied a due process analysis that cherishes form over substance and ignores the significant contacts created by an in-state beneficiary. Its analysis is inconsistent with both this Court's modern due process

jurisprudence and its longstanding precedents regarding trust taxation, neither of which relies mechanistically on the trustee's actions. The *amici* states have an abiding interest in this Court maintaining flexible due process standards and rejecting the North Carolina court's deviation from them.

## SUMMARY OF ARGUMENT

The North Carolina Supreme Court's decision in this case conflicts with this Court's precedents and should be reversed. This Court has consistently looked to the substance, and not the form, of transactions for the purposes of its due process analysis, and does not adhere to formalistic rules in determining when constitutional minimum contacts have been satisfied. *See South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2093-94 (2018) (quoting *Quill Corp. v. North Dakota*, 504 U.S. 298, 308 (1992)). The decision in the case below imposes a formalistic standard that would disregard significant in-state contacts in the trust context. This is inconsistent with this Court's modern due process jurisprudence as it relates to taxation, which focuses on contacts with the forum rather than literal presence of persons or property, and should not be adopted.

The decision below also infringes on state sovereignty, and usurps legislative authority regarding taxation. Subject to the constitutional requirement of due process, state legislatures should be free to formulate state-specific policies regarding the taxation of trusts, rather than being bound to a formal requirement that a trustee or trust property must be

located in-state. All but seven states impose taxes on the income of trusts, and *three quarters* of those states predicate these taxes, in whole or in part on factors other than the location of the trustee. If affirmed, the decision below will call into question the statutory structures of all of these jurisdictions. Finally, the formalistic analysis proposed by the court below would cause the states to face a significant loss in tax revenues, if affirmed.

## ARGUMENT

### I. THE NORTH CAROLINA SUPREME COURT'S DECISION REPRESENTS A REVERSION TO A FORMALISTIC DUE PROCESS STANDARD THAT DISREGARDS ESSENTIAL TRUST CONTACTS.

#### A. The North Carolina Supreme Court's Decision Conflicts With This Court's Modern Due Process Jurisprudence.

By holding that only the trustee's contacts with a state are relevant to making the minimum-contacts determination, North Carolina has reverted to a formalistic rule that elevates substance over form. *See* Pet, App. 12a-13a. The decision dictates that the form of a trust is primary, and that because of this, the due process contacts of other parties to the trust like the beneficiary are irrelevant. *Id.*

This Court has long recognized, however, that for due process purposes, "[w]hen the question is whether a tax imposed by a State deprives a party of rights secured by the Federal Constitution, ... [w]e must regard the substance, rather than the form, and the controlling test is to be found in the operation and

effect of the law as applied and enforced by the State." *Lunding v. N.Y. Tax Appeals Tribunal*, 522 U.S. 287, 297 (1998) (*citing St. Louis Sw. R. Co. v. Ark.*, 235 U.S. 350, 362 (1914)). In order to give precedence to substance over form, and in recognition of "modern commercial life," the Court has ruled consistently that the Due Process Clause does not require the use of formalistic tests. *Quill*, 504 U.S. at 308 (*citing Int'l Shoe Co. v. Wash.*, 326 U.S. 310 (1945)).

Instead of a formalistic standard, due process for tax purposes long has been evaluated according to the more flexible standards set forth in *International Shoe* — specifically, whether a taxpayer has purposefully availed itself of the benefits of the taxing state. *Quill*, 504 U.S. at 307-08 (but also finding that a physical presence test was appropriate under the Commerce Clause for sales tax purposes). Once purposeful availment has occurred, the Due Process Clause merely requires that there be a rational relationship between the income attributed to a state and values connected with the state. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-273 (1978).

A fair and flexible standard consistent with this Court's modern due process jurisprudence would recognize the reality that the trust itself retains significant actual connections to its grantor and, even more importantly, to its beneficiaries, who are the equitable owners of the trust's assets. *See* Restatement (Third) of Trusts § 2 (2003) (explaining that trust beneficiaries hold equitable title to trust property). A proper due process standard would therefore consider, at the least, (1) the location of trustees; (2) the location

of beneficiaries; (3) the location and nature of trust assets; (4) the principal place of trust administration; (5) the location of the trust's creation; and (6) the grantor's domicile. *See e.g., Westfall v. Dir. of Revenue*, 812 S.W.2d 513, 514 (Mo. 1991).

The formalistic standard used by the North Carolina Supreme Court looks only at the first and fourth listed contacts, utterly ignoring the other three.[1] That approach yields perverse results, as can be seen in the Minnesota Supreme Court's similar holding in *Fielding v. Comm'r of Revenue*, 916 N.W.2d 323, 330 (Minn. 2018), petition for cert. pending, No. 18-664 (filed Nov. 15, 2018). Focusing solely on the trustee's lack of contacts with Minnesota, the court held that the State of Minnesota could not tax several trusts' income. That was so, held the court, even though the trusts had a variety of significant connections to the state: (1) they were created by a Minnesota resident; (2) their assets consisted of stock in a closely held corporation headquartered and operating in Minnesota; (3) the trust agreements were drafted in Minnesota and are governed by Minnesota law; (4) the grantor resided in Minnesota when the trusts became irrevocable; and (5) one of the beneficiaries resided in Minnesota. *Id.* at 330-333. The Minnesota Supreme Court deemed all of those contacts "irrelevant" for due process purposes because the trust was administered by a Texas resident during the tax year at issue. *Id.*

The approach taken by the Minnesota and North Carolina Supreme Courts contravenes this Court's

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[1] The court left open the possibility that real property owned by a trust could create relevant in-state contacts. Pet. App. at 35a.

modern precedents with respect to state taxation. As this Court explained in *Wayfair*, 138 S. Ct. 2080 (2018), in reversing its prior Commerce Clause jurisprudence regarding sales taxes, the Constitution does not command "arbitrary, formalistic distinction[s]." *Id.* at 2086. "It is essential to public confidence in the tax system that the Court avoid creating inequitable exceptions." *Id.* The North Carolina Supreme Court's rule would substantially undermine public confidence in state income tax systems because it would provide a substantial and unwarranted tax benefit to trust beneficiaries, which would not be extended to others.

As multiple other state courts of last resort have determined, a state can maintain constitutionally sufficient contacts with a trust through contacts with its grantor and beneficiaries, and not simply with an in-state trustee. *See e.g., McCulloch v. Franchise Tax Bd.*, 390 P.2d 412, 418 (Cal. 1964) (sustaining as constitutional a resident income tax founded upon residence of beneficiary);*Westfall v. Dir. of Revenue*, 812 S.W.2d 513 (Mo. 1991); *Dist. of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. 1997); *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999); *T. Ryan Legg Irrevocable Trust v. Testa*, 75 N.E3d 184 (Ohio 2016). The rule employed in the North Carolina Supreme Court's decision is inconsistent with this Court's decisions in *Lunding, Quill,* and *Wayfair,* and should be reversed.

### B. The North Carolina Supreme Court's Decision Conflicts With This Court's Trust Taxation Jurisprudence.

The North Carolina Supreme Court's decision also conflicts with the longstanding, still valid, holding in *Curry v. McCanless*, 307 U.S. 357 (1939). In *Curry*, this Court held that a trust could be subject to inheritance taxes in more than one state, when the trustee was located in one state and the trust's grantor and beneficiaries were located in another state. *Id.* at 368. In evaluating the trust's contacts for due process purposes, this Court determined that the contacts of both the trustee, and the trust's grantor and beneficiaries, were relevant in determining where the trust could be subject to taxation under the Due Process Clause. *Id.*

Central to this Court's ruling in *Curry* was the trust's management (as here) of intangible property, rather than tangible property. This Court explained that because intangible property does not occupy a fixed place in the physical world, unlike tangible property, it can create constitutionally sufficient contacts in multiple jurisdictions simultaneously. *Curry*, 307 U.S. at 368-369 (cautioning against "first ascribing to them a fictitious situs and then invoking the prohibition of the Fourteenth Amendment against their taxation elsewhere," in an effort to "prevent the taxation of diverse legal interests in intangibles in more than a single place"). Those principles cannot be reconciled with a rule that the only constitutionally relevant contact a trust has with a state is the situs of the trust and its trustee.

To be sure, *Curry* did not present precisely the same issue as this case. Most notably, *Curry* involved inheritance and transfer taxes on a trust's corpus, not income taxes. However, the central holdings of *Curry* bear directly on the present case: (1) the Due Process Clause does not confine the situs of intangible property to a single jurisdiction for tax purposes; and (2) contacts of both trustees and other parties to a trust are relevant for the purposes of the Due Process Clause. As *Curry* explained, in words that resonate here:

> We can find nothing in the history of the Fourteenth Amendment and no support in reason, principle, or authority for saying that it prohibits either state, in the circumstances of this case, from laying the tax. On the contrary this Court, in sustaining the tax at the place of domicile in a case like the present, has declared that both the decedent's domicile and that of the trustee are free to tax.

307 U.S. at 372–73 (1939) (internal citations omitted). *See also* Hellersten, Hellerstein, & Swain, State Taxation, at ¶ 20.09[2][a] (3d ed. 2018) (explaining that the holding in *Curry* substantially undermines the argument that states are constrained by the Due Process Clause from levying resident income taxes on trusts with on out-of-state trustees when the trust has other in-state contacts). This Court should reaffirm *Curry* and reject the ruling of the North Carolina Supreme Court.

## II. THE DECISION BELOW WOULD IMPOSE A STRAIGHTJACKET ON STATES AND CAST IN DOUBT THE MAJORITY OF STATES' TAXING REGIMES.

This Court has long recognized that state legislatures "have considerable discretion in formulating tax policy." *Lunding v. N.Y. Tax Appeals Tribunal*, 522 U.S. 287, 297 (1998) (*citing Madden v. Kentucky*, 309 U.S. 83, 88 (1940)). The decision below significantly encroaches on that discretion because it concludes that only a trustee's contacts are constitutionally relevant for due process purposes. The majority of state statutes providing for trust taxation call for the consideration of factors other than the trustee's contacts, such as the contacts of grantors and beneficiaries. *See infra* fn. 4 and 5. Legislators in states utilizing these statutes presumably relied on this Court's ruling in *Curry* when concluding that they had the constitutional authority to tax trusts administered in other states based on the relevant contacts of grantors and beneficiaries. If affirmed, the rule proposed by the North Carolina Supreme Court would effectively establish a uniform national standard for trust taxation, and deprive states of the sovereign right to formulate tax policy pertaining to trusts.

Although states clearly have the authority to tax trusts on the basis of the location of a trustee, only twelve of the forty-four states imposing an income tax on trusts use the location of the trustee as the primary consideration in determining residency ("trustee-

domicile rules").[2, 3] Rather, the majority of states (twenty-seven) provide for some form of trust income taxation based on either the location of the beneficiary ("beneficiary-domicile rules") or the location of the grantor ("grantor-domicile rules"), without reference to the location of the trustee.[4] In a small number of states

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[2] For the purposes of this discussion the term "states" includes the District of Columbia. States that do not impose income taxes (on trusts or otherwise) include: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

[3] We define trustee-domicile rules as those that impose taxes on the basis of the trustee's state of domicile or the location of the trust's administration. Some trustee-domicile rules also consider secondary factors. *See e.g.*, Mass. Code Regs. § 62.10.1 (2018), providing that an *inter vivos* trust is a resident of Massachusetts if: (1) at least one of the trustees is a Massachusetts resident; and (2) at least one of the grantors is or was a Massachusetts resident. The regulation considers more contacts than just the trustee's, but the trustee's presence is a necessary condition, making it a trustee-domicile rule. *See also* A.R.S. § 43-1301 (2018); Ark. Code Ann. § 26–51–201(a) (2018); Colo. Rev. Stat. § 39–22–103(10) (2018); Haw. Rev. Stat. § 235-1 (2018); Ind. Admin. Code tit. 45, r. 3.1-1-12 (2018); Kan. Stat. Ann. § 79-32,109(d) (2018); Ky. Rev. Stat. Ann. § 141.030 (2018); Miss. Code Ann. § 27-7-5(1) (2018); N.M. Stat. Ann. § 7-2-2(S) (2018); Or. Rev. Stat. § 316.282(1)(d) (2018); S.C. Code Ann. § 12–6–30(5) (2018).

[4] There are many nuances to the beneficiary-domicile and grantor-domicile rules amongst the states. For example, in Minnesota, trusts settled before 1995 are subject to a trustee-domicile rule, but trusts settled after 1995 are subject to a grantor-domicile rule. *See* Minn. Stat. § 290.01, subd. 7b (2018). Some other states have different rules for testamentary versus *inter vivos* trusts. *See, e.g.*, 830 Mass. Code Regs. § 62.10.1 (2018), providing that testamentary trusts of Massachusetts domiciliaries are subject to a grantor-domicile rule, while, as observed *supra* in fn. 2, resident *inter vivos* trusts are subject to a trustee-domicile rule. *See also* Conn. Gen. Stat. § 12-701 (2018); Del. Code Ann. tit. 30 § 1601

(six), multiple factors are considered, which sometimes include the location of the trustee, but not as a necessary condition for the imposition of the resident income tax.[5] For example, Alabama law provides that a testamentary trust is an Alabama resident trust if it: (1) is established by a decedent domiciled in Alabama; and (2) either the trustee or one of the trust beneficiaries was domiciled in Alabama for seven months of the tax year. Ala. Code § 40-18-1(33). Under the Alabama rule, the presence of a trustee is a relevant and potentially sufficient condition for the imposition of the tax, but it is not a necessary condition. The presence of the grantor at death and a beneficiary in a following year is also sufficient. *Id.* California, another multi-factor state, taxes trusts as residents if they either: (1) have a resident trustee; or

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(2018); D.C. Code § 47-1809.01 (2018); Del. Code Ann. tit. 30, § 1601(8) (2018); Ga. Code Ann. § 48–7–20(d) (2018); 35 Ill. Comp. Stat. 5/201 (2018); Iowa Admin. Code § 701-89.3 (2018); La. Stat. Ann. § 47:300.10 (2018); Me. Rev. Stat. Ann. tit. 36, § 5102(4) (2018); Md. Code Ann., Tax-Gen. § 10-101 (2018); Mich. Comp. Laws § 206.18 (2018); Minn. Stat. § 290.01 (2018); Mo. Rev. Stat. § 143.331 (2018); Mont. Admin. R. 42.30.101 (2018); Neb. Rev. Stat. Ann. § 77-2714.01 (2018); N.H. Rev. Stat. Ann. § 77:10 (2018); N.J. Stat. Ann. § 54A:1-2 (2018); N.Y. Tax Law § 605 (2018); N.C.G.S.A. § 105-160.2 (2018); Okla. Stat. tit. 68, § 2353 (2018); 72 Pa. Cons. Stat. § 7301 (2018); R.I. Gen. Laws § 44-30-5 (2018); Tenn. Code Ann. § 67-2-110(a) (2018); Utah Code Ann. § 59-10-201 (West 2018); Vt. Stat. Ann. tit. 32, § 5811 (2018); Va. Code Ann. § 58.1-302 (2018); W. Va. Code R. 110- 21-7 (West 2018) ; Wis. Stat. § 71.14(3) (2018).

[5] *See* Ala. Code § 40-18-1(33) (2018); Idaho Code § 63-3015 (2018); Cal. Rev. & Tax. Code §§ 17041, 17731, 17742, 17743; 17745 (2018); Mont. Admin R. 42.30.101 (2018); N.D. Admin R. 81-03-02.1-04 (2018); Ohio Rev. Code § 5747.01(I)(3).

(2) have a resident non-contingent beneficiary.[6] Again the presence of a trustee is a sufficient, but not a necessary condition.

Beneficiary-domicile states, grantor-domicile states, and states with multi-factor statutes (a total of thirty-three of the forty-four states imposing income taxes) will all be affected by the Court's decision in this case.[7] This is so because each of their statutes or rules expressly provides for the taxation of certain trusts administered in other states as residents, without reference to the contacts of the trustee. If the decision of the North Carolina Supreme Court is affirmed, the trust income taxation regimes of all of these jurisdictions will be called into question. This result would represent a significant encroachment on state sovereignty and is not required under the Fourteenth Amendment. *See Wayfair*, 138 S. Ct. at 2095-96 (noting that the Court should avoid "intrud[ing] on states' reasonable choices in enacting their tax systems" and observing that formalistic rules are inconsistent with the goals of "federalism and free markets").

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[6] Cal. Rev. & Tax. Code §§ 17041; 17731; 17742; 17743 (2018). California taxes trusts on the basis of beneficiary residence alone only when the beneficiary's interest in the trust is non-contingent. Nevertheless, when a previously contingent beneficiary receives a distribution from the trust, California will impose tax upon that distribution, even if it represents income accumulated during the period that the beneficiary's interest was contingent. Cal. Rev. & Tax. Code § 17745 (2018).

[7] Notably, even Washington, a state with no income tax, foresees negative consequences resulting from a constrained reading of the Due Process Clause and has joined the other *amici* asking this Court to reverse.

## III. If the Decision of the North Carolina Supreme Court is Affirmed, it Will Create a Constitutionalized Tax Loophole For Trust Beneficiaries.

This Court recently admonished against the creation of "judicially created tax shelter[s]." *Wayfair*, 138 S. Ct. at 2085. Yet that is precisely what the North Carolina Supreme Court's due process ruling does. By their nature, trusts are extraordinarily mobile and versatile. *See* Stewart Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 Cornell L. Rev. 1035, 1065 (2000). As the need for federal estate tax planning has diminished over time due to the increasing exemption amount, estate planners have increasingly targeted state income taxes for minimization through various forum shopping strategies. *See* Jay Soled and Mitchell Gans, *Asset Preservation and the Evolving Role of Trusts in the Twenty-First Century*, 72 Wash. & Lee L. Rev. 257, 277-280 (2015). The North Carolina court's rule makes it surpassingly easy for them to accomplish that goal and avoid *all* state taxes on trust income: simply park interest and dividend bearing assets such as securities into a trust that is administered in one of the seven states that does not impose an income tax. No other step is required, and the trust beneficiary achieves complete avoidance of state income taxation on their investment income.

And under the North Carolina Supreme Court's rule, individuals could avoid taxes on large capital gains, even when the accretion of wealth underlying the transaction took place while the taxpayer was

enjoying the protections of the laws and services of their state of domicile. The *Fielding* case discussed above is a perfect example. A trustee in Texas sold stock in a closely held family business that was headquartered in Minnesota for over 100 years, and was owned and operated by a Minnesota grantor — yet Minnesota was barred from taxing the capital gain because the Minnesota Supreme Court found that the business's ties to the State were "irrelevant" to the taxation of the trustee under the Due Process Clause. *Fielding* 916 N.W.2d at 326-333. Results like these threaten to dramatically undermine public confidence in our nation's tax system, as large tax benefits are conferred to trust beneficiaries but not others. Further, the resulting lack of confidence threatens to exacerbate the problem of non-compliance with all state and federal tax laws. *See* Dave Rifkin, *A Primer on the "Tax Gap" and Methodologies for Reducing It*, 27 Quinnipiac L. Rev. 375 (2009) (explaining that perceived unfairness in the income tax system drives increased noncompliance).

This concern is real. Experts have observed that "[o]ne of the most significant reasons for moving the situs of a presently existing (nongrantor) trust is to move an income-accumulation trust from a high income tax state to a low income tax state.". John Warnick and Sergio Pareja, *Selecting a Trust Situs in the 21st Century*, 16 Probate & Property 53, 57 (2002). This strategy is not limited to existing trusts, of course, as newly formed trusts adhere to the "basic" but "critical" strategy of "avoiding the selection of a trustee domiciled in a state that predicates taxation based upon a trustee's residency." Jay Soled and Mitchell

Gans, 72 Wash. & Lee L. Rev., at 277, n. 129 (2015). If the decision of the North Carolina Supreme Court is affirmed, tax avoidance through the use of out-of-state trustees will become even more prevalent.

State revenue shortfalls will not be minor. The North Carolina Department of Revenue has received more than 450 refund claims (so far) based on the outcome of this case, and the Minnesota Department of Revenue has received over 300 refund claims based on the outcome of *Fielding*. If the decision of the court below is affirmed, such claims will be filed in states across the country, which will create revenue losses that will be borne for years to come. The most recent data available on a nationwide scale shows that trusts filed 2.7 million returns in 2014, and paid federal taxes of more than $120 billion. Pet. at 12. There is a corollary state income tax for the vast majority of those 2.7 million trusts under current state statutes, and if they are allowed to completely avoid the payment of state income taxes based on a formalistic reading of the Due Process Clause, the majority of states will face real declines in state revenues.

Meanwhile, states continue to provide benefits and protections to their residents (and their interests in trust funds), even where the trustees reside and administer the trusts in other states for tax avoidance purposes. "The private enrichment that these newly minted trusts offer often comes at tremendous financial costs to the public." Soled and Gans, 72 Wash. & Lee L. Rev., at 295-96. This Court has long held that states' constitutional authority for imposing income taxes on their residents under the Due Process Clause

is inherent, and based on the states' offering the protections of its laws to in-state residents. *People of State of N. Y. ex rel. Cohn v. Graves*, 300 U.S. 308, 313, 57 S. Ct. 466, 467, 81 L. Ed. 666 (1937). Affirming a rule that would allow tax avoidance by in-state trust beneficiaries is fundamentally inconsistent with this principal; the Constitution does not mandate it and the Court ought to reject it.

## CONCLUSION

For the foregoing reasons, the judgment of the North Carolina Supreme Court should be reversed.

Respectfully Submitted,

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